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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1943

No. 445

BONWIT TELLER, INC.,

Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF.

ARTHUR B. HYMAN,
Counsel for Petitioner.

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1943

No. 445

BONWIT TELLER, INC.,

against *Petitioner,*

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI.

May It Please the Court:

The petition of Bonwit Teller, Inc., respectfully shows to this Honorable Court:

"A."

Summary Statement of Matter Involved.

The proceedings involve a deficiency in Federal income taxes assessed against the petitioner for the year ending January 31, 1939, amounting to $5,844.63. The deficiency resulted from the disallowance by the Commissioner of Internal Revenue of a deduction from gross income for depreciation of certain permanent building improvements installed at a cost of $618,964.54 by petitioner's predecessor in a tax-free reorganization.

The Tax Court of the United States sustained the Commissioner and was in turn sustained by the United States Circuit Court of Appeals for the Second Circuit.

"B."

Jurisdiction.

1. The statutory provision believed to sustain jurisdiction is Section 240 of the Judicial Code as amended by the Act of February 13, 1925 (Chapter 229, Sec. 1, 43, Stat 938).

2. The decision sought to be reviewed was filed on July 7, 1943; rehearing was denied on July 28, 1943, and the mandate of the Court was entered on the same day.

3. The proceeding in which review is sought was instituted in the Tax Court of the United States. It involves the right of the petitioner, as transferee in a tax-free reorganization, to depreciate permanent improvements installed in leased premises by its predecessor and used therein by it and, after reorganization, by petitioner. The right to the deduction was asserted under the provisions of Sections (23l), (23n), 113 and 114 of the Revenue Act of 1938 (c. 289, 52 Stat. 447). A deficiency order was entered by the Tax Court of the United States and a petition for review was duly filed in the Circuit Court of Appeals for the Second Circuit, which affirmed the determination of the Tax Court.

4. The cases believed to sustain jurisdiction are:

Virginian Hotels Corp. v. *Helvering,* 319 U. S. —;
Detroit Edison Co. v. *Commissioner,* 319 U. S. —;
Duffy v. *Central R. R.,* 268 U. S. 55;
Helvering v. *Lazarus,* 308 U. S. 252;
Nelson v. *Helvering,* 296 U. S. 374.

"C."

Questions Involved.

1. In a tax-free reorganization, predecessor corporation transfers to its successor, in exchange for stock of the latter, all its assets (except leaseholds), including building improvements installed by it and used in its trade and business. The latter, upon its undertaking to pay the rental and other charges reserved in its predecessor's lease and to fully comply with the terms thereof during its occupancy, continues in possession of the premises with the consent of the landlord, pays the rent and other charges and fulfills the covenants of the lease. Without change of management or personnel it continues to carry on the business of its predecessor and continues the use of the demised premises and the building improvements. Does the exclusion from the transfer of its predecessor's lease of the premises preclude the successor corporation from taking a deduction from income of depreciation on such building improvements?

2. Does the execution by lessor and lessee of a new lease modifying the original lease by reducing the term and the rental reserved, extinguish the lessee's right to continue for income tax purposes to take depreciation on building improvements installed by it in the leased premises?

3. Does the subsequent execution of a new lease by the successor corporation with a new owner of the premises, preclude the successor corporation from continuing to take similar depreciation?

4. Does the right to recover a capital investment in building improvements through charges to depreciation, depend upon the existence of a lease?

The material facts, stated as briefly as possible, are as follows:

Petitioner's predecessor, Bonwit Teller & Co., occupied premises 721 Fifth Avenue under a twenty-one year lease, expiring in 1951 (R. 173). Upon taking possession it had installed permanent improvements at a cost of $618,964.54, having an estimated useful life of twenty years, upon which it took annual deductions for depreciation (R. 174). It encountered financial difficulties which made it necessary for the company to obtain two successive reductions in rent (R. 275), the second one resulting in a modification of its lease, evidenced by the execution of a new lease dated December 14, 1932, and, because of the reduced rental, running to September 30, 1938, and containing a ninety-day cancellation clause at the landlord's option (R. 175, 281). Finally it was compelled to go through reorganization. On July 25, 1933, the petitioner was organized and to it were transferred, in exchange for shares of its capital stock, all the assets of its predecessor including "merchandise, furniture, fixtures, improvements and equipment." Excluded from the transfer, however, was the lease of premises 721 Fifth Avenue and leases on certain other premises not involved in this proceeding (R. 176, 282).

The petitioner continued in possession of the leased premises with the consent of the landlord upon its agreement to pay the rent and other charges reserved in its predecessor's lease and to fulfill the covenants thereof so long as it remained in possession. It continued to conduct the business formerly conducted by its predecessor without change of management or personnel and to use in the business the improvements installed by its predecessor (R. 184, 282). In 1933 and 1934 it made additional improvements to the building located on the leased premises at a cost of $3,741.61 (R. 180). On its income tax returns for

the years 1933 to 1936 it claimed depreciation on the building improvements installed by its predecessor and on those installed by it at the rate of 5% per annum. Its returns for those years showed losses for each year and were duly audited by the Commissioner of Internal Revenue and accepted as correct (R. 174).

In April, 1937, the owner of the premises sold the same (R. 183). The agreement preceding the sale stated that it was subject to the original lease of April 7, 1930 and the modified lease of December 14, 1932 entered into by petitioner's predecessor (R. 232, 264), and both the agreement and the instrument of conveyance stated that the premises were sold subject "to the rights of the tenant in possession" (the petitioner) (R. 233, 265). Subsequently, in December of that year, petitioner entered into a new lease with the then owner of the realty for a term extending to January 31, 1950, which took up approximately the balance of the term of the original lease made in 1930 by its predecessor. It is still occupying the premises and using the building improvements in its trade and business (R. 184).

Petitioner's predecessor was adjudicated a bankrupt almost immediately after it transferred its assets to the petitioner in 1933, and on December 5, 1937 it was dissolved by proclamation (R. 180, 190).

It has been stipulated that the foregoing transfer was part of a tax-free reorganization (i. e., one in which neither gain nor loss was realized by either party). It has also been stipulated that if the petitioner is entitled to depreciate the improvements then the basis of such improvements is the adjusted basis in the hands of its predecessor as of the date of the transfer (R. 176, 177).

"D."

Reasons Relied On for the Allowance of the Writ.

1. The absolute statutory right of the petitioner to depreciate the building improvements installed by its predecessor has been denied by the Court below (Sec. 23 (l), 23 (n), 113, 114 I. R. C.). Its decision violates the plain intent of the statutes as well as the principle laid down by this Court in *Helvering* v. *Lazarus* (308 U. S. 252), and *Detroit Edison Company* v. *Commissioner* (319 U. S. —), and more recently repeated in *Virginian Hotels Corp.* v. *Helvering* (319 U. S. —), that a taxpayer's right to recover its investment in a wasting asset flows from *the making of the investment* and the use of the assets in trade and business.

2. The Circuit Court's holding that the acquisition by petitioner of the lease of its predecessor is a prerequisite to the right to depreciate, finds no support in the statutes or in the decided cases and is legally unsound in principle. It is in direct conflict with the decision in *Simon Bricks Co.*, 14 B. T. A. 878, affirmed 45 Fed. (2d) 57, (C. C. A. 9); cert. den. 283 U. S. 834, where improvements made on premises by a tenant at will were held depreciable over the useful life of the improvements; with the case of *George H. Bowman* v. *Commissioner*, 32 Fed. (2d) 404, (Ct. of Appeals, District of Columbia) involving a tenancy from month to month; and with the case of *Elmira Arms*, 7 B. T. A. 703, where depreciation was permitted on a building erected by the taxpayer on premises upon which he had no lease at all. It is also in conflict with *B. Kirk Rankin*, 17 B. T. A. 130; affirmed 60 Fed. (2d) 76, (C. C. A. 6), where the taxpayer was allowed depreciation on improvements installed on property which he had only a contract to purchase.

3. The Circuit Court's holding that petitioner did not acquire its predecessor's estate is contrary to the law of the

State of New York, under which petitioner became the assignee of its predecessor's term, bound over by privity of estate with the landlord to meet the obligations of the lease so long as it remained in possession (*Mann* v. *Munch Brewery*, 225 N. Y. 189; *Frank* v. *N. Y. L. E. & W. R. R. Co.*, 122 N. Y. 197; *Gillette Brothers* v. *Aristocrat Restaurant*, 239 N. Y. 87).

4. The decision below is of far-reaching importance because of its impact upon the depreciation and reorganization provisions of the Internal Revenue Code. Its effect is to frustrate the Congressional will and purpose and to create doubt and uncertainty where neither should prevail. Unless corrected, it will militate against a sound administration of the applicable Code provisions and will give rise to needless controversy and litigation.

WHEREFORE, petitioner respectfully prays that a writ of certiorari issue out of and under the seal of this Honorable Court, directed to the Court of Appeals of the Second Circuit, commanding that Court to certify and send to this Court for its review and determination on a day certain therein to be named, a full and complete transcript of the record and of the proceedings in this case numbered and entitled on its docket No. 18585, Bonwit Teller, Inc. *v.* Commissioner of Internal Revenue, and that said decision of the Circuit Court of Appeals for the Second Circuit may be reviewed by this Honorable Court, and that this petitioner may have such other and further relief in the premises as to this Honorable Court may seem meet and just; and your petitioner will ever pray.

BONWIT TELLER, INC.,
By ARTHUR B. HYMAN,
Counsel for Petitioner.

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

I.

Opinions of the Courts Below.

The opinion of the Circuit Court of Appeals for the Second Circuit was rendered on July 7, 1943. It is reported in 136 Fed. (2d) 978, and is to be found on pages 126 to 130 of the record herein.

The opinion of the Tax Court of the United States is reported in 46 B. T. A. 978 (No. 130), and appears on pages 30 to 41 of the record herein.

II.

Jurisdiction.

The grounds upon which the jurisdiction of this Court is invoked are set forth in subdivision marked "B" of the petition submitted together with this brief.

III.

Statement of the Case.

A full statement of the case has been given under heading "C" in the petition, and in the interest of brevity is not repeated.

IV.

Specification of Errors.

The Circuit Court of Appeals for the Second Circuit erred in the following respects:

1. In holding that petitioner, a transferee in a tax-free reorganization, is not entitled to depreciate the improvements made by its predecessor.

2. In failing to reverse the deficiency order of the Tax Court of the United States.

V.

THE ARGUMENT.

Summary.

Petitioner acquired all its assets from its predecessor in a tax-free reorganization. The building improvements involved in this controversy were a part of the assets so acquired. As a part of the transaction, the petitioner was let into possession of the premises under an existing lease and continued the occupancy of its predecessor, upon its agreement to pay the rental and all other charges reserved therein so long as it continued in possession. Since the date of the reorganization, it has remained in possession of the premises without interruption, using the building improvements in question in its trade or business, and has fulfilled the covenants of its predecessor's lease as well as the lease it subsequently entered into. Under the circumstances, it is entitled to exhaust the cost of those improvements as well as the improvements subsequently installed by it over their useful life by annual charges for depreciation.

Point I.

The Petitioner as Transferee in a Tax-Free Reorganization Is Entitled to Depreciate Improvements Installed by Its Predecessor.

The Circuit Court's decision has completely overlooked certain statutory rights which petitioner acquired by virtue of its status as transferee in a tax-free reorganization. This is apparent from the Court's statement that the petitioner "invested nothing in the improvements."

To entitle a taxpayer to depreciate permanent building improvements, he need not have installed them himself. He

may have received the improved leased property by way of gift, or gift in trust, or through inheritance. In such case, their adjusted basis in his hands, as defined by statute (I. R. C. Sec. 114) is deemed his capital investment, which he is allowed to recoup by annual deductions for depreciation. Or the improvements or the right to use them may have been acquired from a previous tenant, in which case the purchase price or other consideration paid for that right is the investment which may be recovered by depreciation deductions (*Virginian Hotels Corp.* v. *Helvering,* 319 U. S. —; *Cogar* v. *Commissioner,* 44 Fed. (2d) 554, rehear. den. 51 Fed. (2d) 501; *Commissioner* v. *Neighbors Realty Co.,* 81 Fed. (2d) 173; *Midtown Tower Inc.,* 40 B. T. A. 116).

Or, again, as in the case at bar, the taxpayer may have acquired the right to use the property in a tax-free reorganization, in which event it is entitled to use its predecessor's basis for depreciation (*Claridge Apts.,* 1 TC No. 21; *Schweitzer* v. *Conrad, Inc.,* 41 B. T. A. 533; Sec. 113, 114 I. R. C.); this is because in such a reorganization there is "a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization" (Code of Federal Regulations, Title 26 I. R., Reg. 103, Sec. 112 (g)-1).

It having been stipulated that the transfer by which the petitioner acquired the right to use the improvements was part of a tax-free reorganization, its right to depreciate the improvements installed by its predecessor follows as a matter of course. Because of the identity of interest of transferor and transferee which characterizes a statutory reorganization, the transferor's investment is made the investment of the transferee, and the former's statutory right to recoup its investment by annual charges to depreciation

becomes the transferee's right. In this manner the legislative purpose of the depreciation allowance, namely, the recovery of an investment in a wasting asset, is fulfilled (Sections 113, 114 I. R. C.).

The Courts below allowed themselves to be diverted from the real points in the case by a consideration of details which had no important bearing upon the basic fact that petitioner acquired the right, title and interest of its predecessor in and to the building improvements and continued, and still continues, to use them in its trade and business.

The Circuit Court dealt tentatively with the question whether the execution by the predecessor and its landlord of a new lease shortening the term and reducing the rental had any effect upon its right to continue to take depreciation, and relegated that question to the background on the theory that it might be "unduly technical".

However, the Court followed its admittedly technical reasoning with the equally technical argument that the exclusion of the lease in the reorganization and the execution of a new lease at a subsequent date did affect the petitioner's right to depreciate the improvements, notwithstanding that there was no interruption in the occupancy of the demised premises nor of possession and use of the building improvements. The Court completely misconceived, on the one hand, the effect of the exclusion of the lease, *which was merely to avoid the assumption by petitioner of a contractual obligation while leaving it liable on the covenants of the lease so long as it remained in possession;* and, on the other, the effect of the execution by petitioner of a new lease in 1937, which merely continued the tenancy and the use of the improvements and consequently perpetuated the right to depreciate instead of extinguishing it. (*The Cleveland Ry. Co.*, 36 B. T. A.

208; *Harris-Emery Co.*, 37 B. T. A. 958; *B. Kirk Rankin*, 60 Fed. (2d) 76).

The existence of a lease of premises on which improvements have been installed has nothing whatever to do with the *right* to depreciate such improvements. The term of a lease is merely a convenient mathematical aid in fixing the time within which the statutory right to depreciation will be exercised and in computing the *rate* at which the depreciation will be taken.

Although in those cases where the courts have had occasion to pass upon a taxpayer's right to depreciate permanent improvements, the taxpayer's occupancy usually has been under a lease, nevertheless, in all the cases, the *sine qua non* of the right to depreciation has been held to be the making of the investment and the use of the property in trade and business, not the ownership of the property or the existence of a lease. (*Helvering* v. *Lazarus*, 308 U. S. 252; *Weiss* v. *Weiner*, 279 U. S. 333; *Rankin* v. *Commissioner*, 60 Fed. (2d) 76; *Detroit Edison Co.* v. *Commissioner*, 319 U. S. 98), and there have been a number of cases with which the Circuit Court's decision conflicts, where the depreciation allowance was granted despite the absence of a lease (*George H. Bowman* v. *Commissioner*, 32 Fed. (2d) 404, Ct. of Appeals, Dist. of Col., (month to month tenancy); *Simon Bricks Co.*, 14 B. T. A. 878; affirmed 45 Fed. (2d) 57, cert. den. 283 U. S. 834, C. C. A. 9, (tenancy at will); *Elmira Arms*, 7 B. T. A. 703 (no lease at all).

In the *Bowman* case, the Court pointed out that it was sufficient to entitle a taxpayer to depreciation if "it is shown that the tenancy extended for a period substantially beyond the taxpayable year in which the adjustment for the improvements is claimed."

The Circuit Court's holding that "petitioner never succeeded to the term of the old company" is contrary to the law of the State of New York. Assuming, for the sake of argument, that at the time of the transfer petitioner was required to succeed to its predecessor's term before acquiring its predecessor's right to depreciate the improvements, this requirement has been fully met. Under the law of the State of New York, "as long as the leasehold estate was in existence, no person or body corporate could give it authority to enter *except under the lease.*" (*Frank* v. *N. Y. L. E. & W. R. R. Co.*, 122 N. Y. 197). "From the fact of possession and the payment of rent it is to be presumed that the (petitioner) was an assignee of the lessee" (*Gillette Bros.* v. *Aristocrat Restaurant*, 239 N. Y. 87), and, paraphrasing the language of *Mann* v. *Munch Brewery*, 225 N. Y. 189, "Payment of rent by the petitioner to the landlord when petitioner has been let into possession by the original lessee, is *prima facie* evidence of the assignment of the whole term."

Point II.

The Cases Cited by the Circuit Court Do Not Support Its Decision.

None of the cases referred to by the Court below in its opinion supports the Court's decision. They really have no application to the question involved.

In *Weiss* v. *Weiner*, 279 U. S. 333 (reversing 27 Fed. (2d) 200), the taxpayer was in the business of taking long term leases on building property and subletting. This Court held that, having made no investment in the buildings, he could not claim depreciation thereon. In *Detroit Edison Company* v. *Commissioner*, 319 U. S. 98, it was held that the investment had been made not by the taxpayer, but by its customers.

In *New Colonial* v. *Helvering,* 292 U. S. 435, it was held that a transferee corporation could not deduct from gross income losses sustained by its predecessor prior to the transfer. There is no statutory provision authorizing such a deduction. There is, however, such authorization for the deduction by the transferee of depreciation of property acquired in the transfer (*Virginian Hotels Corp.* v. *Commissioner,* 319 U. S. —; *Cogar* v. *Commissioner,* 44 Fed. (2d) 554; rehearing den. 51 Fed. (2d) 501).

In *Helvering* v. *Lazarus,* 308 U. S. 252, this Court reaffirmed the basic principle of the depreciation allowance by stating that "one who is not the owner of property may, nevertheless, bear the burden of exhaustion of capital investment."

The cases of *Helvering* v. *Bruun,* 309 U. S. 461, and *Lewis* v. *Pope Estate Co.,* 116 Fed. (2d) 328, upon which the Circuit Court seems to have placed considerable reliance, do not touch the question. Both cases merely set at rest the controversy then existing whether income is realized by the owner when permanent improvements are made to leased premises, or when there is a forfeiture of the leasehold estate and the owner acquires complete possession. Both cases held the latter to be the case. Both have since been superseded by Section 115(a) of the Revenue Act of 1942 which *excludes* from gross income the value of improvements made by a lessee on real property of a lessor. Regardless of the present effect of these decisions, however, the fact remains that here, since the date of the installation of the improvements in 1931, there has been neither a surrender of the premises in which the improvements were installed, nor a cessation of their use in trade or business.

Conclusion.

The question presented, involving as it does the proper interpretation of provisions of the Federal taxing statutes

of far reaching importance, calls for the exercise by this Court of its supervisory powers in order that the decision of the Court below, which deprives taxpayers of a right to depreciation granted by the statutes, may not be perpetuated to petitioner's great detriment and to the great detriment of other taxpayers in like situation.

To that end, a writ of certiorari should be granted, and this Court should review the decision of the Circuit Court of Appeals for the Second Circuit and finally reverse it.

Dated: October 14, 1943.

ARTHUR B. HYMAN,
Counsel for Petitioner.

APPENDIX.

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * *

(l) Depreciation.—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

(n) Basis for Depreciation and Depletion.—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in Section 114.

* * * * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * * * *

(7) *Transfers to corporation.*—If the property was acquired—

(A) After December 31, 1917, and in a taxable year beginning before January 1, 1936, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control of such property of 50 per centum or more remained in the same persons or any of them, or

(B) in a taxable year beginning after December 31, 1935, by a corporation in connection with a reorganization,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

* * * * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

* * * * * * *

Treasury Regulations 103, Code of Federal Regulations, Title 26.

SEC. 19.23(1)-1. Depreciation.—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or treated under section 19.23(a)-15 as held by the taxpayer for the production of income may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of

the depreciable property, equal the cost or other basis of the property determined in accordance with section 113.

* * * * * * *

SEC. 19.112(g)-1. Purpose and scope of exception of reorganization exchanges.—Purpose: Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Internal Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Code, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization.

No. 445

In the Supreme Court of the United States

October Term, 1942

BOWLES, Price Administrator,

v.

CONSOLIDATED, etc., Petitioner,

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 445

BONWIT TELLER, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 30–41) is reported in 46 B. T. A. 978. The opinion of the Circuit Court of Appeals (R. 126–130) is reported in 136 F. 2d 978.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 28, 1943 (R. 141). A petition for rehearing was denied on the same day (R. 140). The petition for a writ of certiorari was filed on October 21, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Ju-

dicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether under Section 23 (l) of the Revenue Act of 1938 the petitioner is entitled to a deduction from its gross income for the taxable year ended January 31, 1939, for depreciation of permanent leasehold improvements installed by the petitioner's predecessor.

STATUTE AND REGULATIONS INVOLVED

The applicable statute and regulations are set forth in the Appendix, *infra,* pp. 12–15.

STATEMENT

The pertinent facts found by the Board of Tax Appeals may be summarized as follows:

Bonwit Teller & Company, the petitioner's predecessor (hereinafter called the old company), leased from 721 Fifth Avenue Corporation at a rental of $475,000 a year certain improved property in New York City, known as 721 Fifth Avenue, for a period commencing May 1, 1930, and ending July 31, 1951 (R. 30–31). In 1931 the old company made certain permanent improvements to the building located on the demised premises at a cost of $618,964.64. Until July 1, 1933, these improvements, which had an estimated life of twenty years, were depreciated by the old company on its income tax returns at the rate of five percent per annum. (R. 31.)

Due to financial difficulties resulting from the depression, the old company later in 1931 succeeding in obtaining a reduction of the fixed annual rental of the premises to $300,000 (R. 31). Financial difficulties continuing, the old company and 721 Fifth Avenue Corporation executed a new lease on December 14, 1932, for the period from that date to September 30, 1938.[1] The new lease provided for a rental of five percent of the old company's receipts from sales on the premises with a fixed minimum of $100,000 per year, but the lessor had the right to terminate the lease on ninety days' notice. Concurrently with the execution of the new lease, 721 Fifth Avenue Corporation placed the premises in control of its mortgagee, the City Investing Company, and the latter thereby became entitled to receive all rents from the old company due under the lease of December 14, 1932. (R. 32.)

The financial difficulties of the old company were still not dispelled and its board of directors took action to organize a new corporation for the purpose of taking over all the assets of the old company (R. 32). On July 6, 1933, the petitioner was organized under the laws of New York, as the Commercial Operating Company

[1] The record discloses that the board of directors of the old company adopted a resolution that the original lease, of April 7, 1930, "be surrendered and cancelled" and at the same time authorized the execution of the new lease (R. 117–118).

(R. 30). Somewhat later, the petitioner's name was changed from Commercial Operating Company to Bonwit Teller, Inc. At the same time, the old company's name was changed from Bonwit Teller & Company to Commercial Operating Company. (R. 34.)

Under date of July 25, 1933, as of the close of business on June 30, 1933, the old company transferred to the petitioner, in exchange for shares of the petitioner's capital stock, all of its assets, including "furniture, fixtures, improvements and equipment," except the lease on the demised premises at 721 Fifth Avenue and all other leases. The petitioner assumed the liabilities of the old company except, *inter alia,* liability under the leasehold estates. This transfer was part of a tax-free reorganization resulting in neither profit nor loss to the old company. (R. 33.) Immediately thereafter, the petitioner entered on its books the assets of the old company at the same amounts as they had been carried on the books of the old company, and included among such assets the leasehold improvements. However, in December, 1936, the petitioner's books were rewritten as of July 1, 1933, and the asset item representing the leasehold improvements was written down to the sum of $1. Since the effective date of the transfer of the assets, the petitioner has claimed depreciation on the improvements made by the old company at the same rate

as that claimed by the old company prior to the transfer. (R. 33–34.)

From on or before April 7, 1930, to the date of the transfer, the old company remained in physical possession of the premises and of the improvements from the date of their installation. Since the transfer, the petitioner has continuously occupied the same premises, together with the improvements.[2] At all times material, it has used the premises and improvements in continuing the business previously conducted by the old company. At the date of the transfer, the personnel of the old company became the personnel of the petitioner, and remained so for some time. No lease was executed in favor of the petitioner until December 1937, as hereinafter set forth. (R. 37.)

The old company was adjudged a bankrupt on August 4, 1933. On or about October 10, 1933, the trustee in bankruptcy notified the lessor of the demised premises, 721 Fifth Avenue Corporation, of the trustee's election not to adopt the lease for the benefit of the bankrupt estate. The old company ceased to do business of any kind after the effective date of the transfer of its assets to the petitioner, and was finally dissolved under the laws of New York on December 15, 1937. (R. 34–35.)[3]

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[2] The record shows that the petitioner's occupancy was by arrangement with the mortgagee in possession (R. 62, 96).

[3] The referee in bankruptcy determined that the transfer of assets to the petitioner in exchange for stock was not

In the meantime, on or about April 1, 1936, the mortgage on the demised premises held by the City Investing Company was assigned to the American Company, a wholly owned subsidiary of the Atlas Corporation. The City Investing Company also assigned to the American Company the right to receive all rents from the tenant under the lease of December 14, 1932, and likewise by assignment the American Company became the lessor of the premises. (R. 35.) Thereupon the American Company organized a wholly-owned subsidiary, the Fifty-Six & Fifth Corporation, for the purpose of acquiring the fee simple absolute of the demised premises from 721 Fifth Avenue Corporation. By agreement of March 30, 1937, 721 Fifth Avenue Corporation sold and conveyed the demised premises to the Fifty-Six & Fifth Corporation subject to the rights of the tenants in possession. (R. 36.)

Under date of December 1, 1937, the petitioner and Fifty-Six & Fifth Corporation executed a lease of the premises at a stated rental for a term beginning December 1, 1937, and ending January 31, 1950 (R. 36). Prior thereto the petitioner

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fraudulent and approved an offer of composition providing for distribution of the petitioner's shares to the creditors of the old company. This action was approved by the District Court and on appeal by the Circuit Court. (R. 35.) For the decision of the Circuit Court, see *In re Commercial Operating Corp.*, 77 F. 2d 285 (C. C. A. 2d), certiorari denied *sub nom. Arnold Constable Corp.* v. *Commercial Credit Corp.*, 296 U. S. 616.

had paid to the City Investing Company for the period commencing August 1, 1933, and ending March 31, 1936, "moneys equal to the amount of rent" provided in the lease dated December 14, 1932. Thereafter until November 30, 1937, the petitioner paid like amounts to the American Company. (R. 37.)

At no time has 721 Fifth Avenue Corporation entered on its books the cost or the value of the improvements to the building located on the demised premises made by the old company in 1931, and at no time has 721 Fifth Avenue Corporation made any claim in its income tax returns for depreciation on such improvements (R. 38).

Upon acquisition, the premises were entered on the books of the Fifty-Six & Fifth Corporation at their cost, measured by the consideration of $500,000 paid by it and the amount of the mortgages assumed by it. The total cost to the Fifty-Six & Fifth Corporation so computed was $5,808,894.82. Of this amount $2,219,224.37, or 38.2039 percent (the percentage of the assessed value of the building to the assessed value of land and building), was entered on the books of the Fifty-Six & Fifth Corporation as the cost of the building on the demised premises. On its income tax returns the Fifty-Six & Fifth Corporation has claimed an estimated useful life of the building of twenty-five years from April 1, 1937, and has deducted depreciation at the rate of four percent per annum. (R. 38.)

The Board of Tax Appeals sustained the deficiency assessed by the Commissioner with respect to deductions for depreciation for the year ending January 31, 1939, holding that the petitioner was not entitled to deductions on account of depreciation of the improvements (R. 30, 38–41). The Circuit Court of Appeals affirmed that decision (R. 126–130).

ARGUMENT

Petitioner's claim that it is entitled to a deduction for depreciation on the leasehold improvements installed by its predecessor, the old company, is without merit, and there is no conflict.

1. Petitioner would be entitled to the depreciation deductions claimed only if it had either made a capital investment in the improvements (*Weiss* v. *Wiener,* 279 U. S. 333; *Detroit Edison Co.* v. *Commissioner,* 319 U. S. 98), or if it had acquired the depreciable cost basis of its predecessor in a tax-free reorganization (Section 113 (a) (7) of the Revenue Act of 1938, Appendix, *infra*). It did neither.

There is no question that petitioner made no capital investment in the improvements involved. Those improvements were installed by the old company in 1931 with its own funds. (R. 31, 58.)

Nor did petitioner, as transferee of the old company in the 1933 reorganization, acquire the latter's depreciable cost basis in the improvements. Under the original 1930 lease the old company was

entitled to depreciation deductions based upon the cost to it of the permanent improvements which it had installed during the pendency of the lease. But on December 14, 1932, when the second lease was executed, the old company by cancelling and surrendering the original lease (R. 117–118) lost its right to depreciate its capital investment,[4] for on that date all property rights in the improvements vested in the lessor, who thereby realized taxable gain and thus was entitled to depreciate in the future the property so acquired. See *Helvering* v. *Bruun,* 309 U. S. 461; *Lewis* v. *Pope Estate Co.,* 116 F. 2d 328 (C. C. A. 9th), certiorari denied, 314 U. S. 630; *Gowern's Estate* v. *Commissioner,* 119 F. 2d 83 (C. C. A. 3d). At the time of the 1933 reorganization, therefore, the old company possessed no depreciable cost basis in the improvements which could have been acquired by petitioner.

Moreover, if the old company had continued to retain a depreciable cost basis after executing the new lease of December 14, 1932, petitioner did not acquire that basis from it in the 1933 reorganization. Whatever right the old company may still have had to depreciation allowances, it possessed as a result of its lease. Only if petitioner had ob-

[4] Where the lease terminates before the lessee has fully recovered its capital investment, it then suffers a deductible loss. *New York Cent. R. R. Co.* v. *Commissioner,* 79 F. 2d 247 (C. C. A. 2d), certiorari denied, 296 U. S. 653; *Washington Catering Co.* v. *Commissioner,* 9 B. T. A. 743.

tained from the old company the latter's lease pursuant to the reorganization would it have acquired the old company's depreciable cost basis. This it did not do. On the contrary, in the reorganization of 1933 the lease of December 14, 1932, was expressly excluded from the transfer of the property of the old company to the petitioner, and it was only at the sufference of the lessor and mortgagee that petitioner was permitted the use and enjoyment of the improvements (R. 33).

2. Even if petitioner had acquired from the old company the latter's depreciable cost basis, it lost its right to depreciation deductions on December 1, 1937, when it executed a new lease with the Fifty-Six & Fifth Corporation, which had purchased the premises in 1937 (R. 36). That new lease effectively superseded the December 14, 1932, lease if the latter still had any force or effect. Thereupon, any right to depreciate which petitioner might have possessed passed to the Fifty-Six & Fifth Corporation. The latter has in fact taken depreciation deductions on the basis of the estimated cost to it of the improvements in question (R. 38).

3. The decision in the instant case is not in conflict with the cases relied upon by petitioner. *George H. Bowman Co.* v. *Commissioner,* 32 F. 2d 404 (App. D. C.); *Simons Brick Co.* v. *Commissioner,* 14 B. T. A. 878, affirmed on other grounds, 45 F. 2d 57 (C. C. A. 9th), certiorari denied, 283

U. S. 834, *Rankin* v. *Commissioner,* 17 B. T. A. 1301, affirmed, 60 F. 2d 76 (C. C. A. 6th), and *Elmira Arms Co.* v. *Commissioner,* 7 B. T. A. 703, involved taxpayers who made capital investments in permanent improvements and who continued to exercise during the taxable year the same right of occupancy under which the improvements were made. They are inapplicable where, as here, the taxpayer made no such investment and where the earlier right of occupancy had been terminated (cf. *Gowern's Estate* v. *Commissioner, supra*). Although petitioner here relies upon its relationship to the entity which did make the investment, and its failure to acquire and retain the lease under which the investment was made is decisive.

CONCLUSION

The petition should be denied.

Respectfully submitted,

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NOVEMBER 1943.

APPENDIX

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

* * * * *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

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SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(7) *Transfers to corporation.*—If the property was acquired—

(A) after December 31, 1917, and in a taxable year beginning before January 1, 1936, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, or

(B) in a taxable year beginning after December 31, 1935, by a corporation in connection with a reorganization,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

* * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

* * * * *

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

Art. 23 (l)-1. *Depreciation.*—A reasonable allowance for the exhaustion, wear and

tear, and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the cost or other basis of the property determined in accordance with section 113. * * *

* * * * *

Art. 23 (l)–4. *Capital sum recoverable through depreciation allowances.*—The capital sum to be replaced by depreciation allowances is the cost or other basis of the property in respect of which the allowance is made. (See sections 113 (a) and 114.) * * *

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ART. 113 (a)–1. *Scope of basis for determining gain or loss.*—The basis of property for the purpose of determining gain or loss from the sale or other disposition thereof is the unadjusted basis prescribed in section 113 (a), adjusted for the various applicable items specified in section 113 (b). Unless otherwise indicated, the word "basis," as used in this article and articles 113 (a)–2 to 113 (a) (18)–1, inclusive, has reference to the unadjusted basis.

Art. 113 (a)-2. *General rule.*—In general, the basis of property is the cost thereof * * *

* * * * *

Art. 113 (b)-1. *Adjusted basis: General rule.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, is the cost of such property or, in the case of such property as is described in paragraphs (1) to (18), inclusive, of section 113 (a), the basis therein provided, adjusted to the extent provided in section 113 (b).

The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. * * *

* * * * *

Art. 114-1. *Basis for allowance of depreciation and depletion.*—The basis upon which exhaustion, wear and tear, obsolescence, and depletion will be allowed in respect of any property is the same as is provided in section 113 (a), adjusted as provided in section 113 (b), for the purpose of determining the gain from the sale or other disposition of such property, * * *.

U. S. GOVERNMENT PRINTING OFFICE: 1943